



STATE OF WASHINGTON

ECONOMIC AND REVENUE FORECAST COUNCIL

Capitol Plaza Building, PO Box 40912 • Olympia, Washington 98504-0912 • (360) 570-6100

May 29, 2007

TO: Governor's Council of Economic Advisors

FROM: ChangMook Sohn, Executive Director
Economic and Revenue Forecast Council

SUBJECT: PRELIMINARY JUNE ECONOMIC FORECAST

This preliminary forecast was based on Global Insight's May Control forecast for the U.S. economy. You should have received a summary of the Global Insight forecast by email. If not, please contact our office. The forecast incorporated the advance GDP estimate for the first quarter of 2007. According to the advance estimate, real GDP growth slowed to just 1.3 percent in the first quarter of 2007 from a revised 2.5 percent in the fourth quarter. The growth rate of final sales was only slightly stronger at 1.6 percent. What little growth there was in the first quarter was more than accounted for by consumer spending which rose at a 3.8 percent rate. Fixed investment declined at a 4.7 percent rate as a result of a 17.0 percent decline in residential fixed investment. The foreign sector was also a drag on growth in the first quarter due to a 1.2 percent decline in exports and a 2.3 percent increase in imports. Government purchases rose at a slight 0.9 percent rate in the first quarter.

Payroll employment growth remained steady at 1.5 percent in the first quarter while the unemployment rate edged up to 4.50 percent from 4.47 percent in the fourth quarter. The Consumer Price Index rose 3.8 percent in the first quarter following a 2.1 percent decline in the fourth quarter. The rebound in inflation was due to energy prices which jumped 16.0 percent in the first quarter following a 34.7 percent decline in the fourth quarter. Core inflation, which excludes food and energy, rose from 1.9 percent to 2.3 percent. Housing starts continued to plunge in the first quarter, falling at a 19.9 percent rate to 1.474 million units. The mortgage rate declined to 6.22 percent in the first quarter from 6.25 percent in the fourth quarter. As expected, the Federal Reserve left its target for the federal funds rate unchanged at 5.25 percent in March and May.

The new national forecast exhibits weaker real growth in the near term. First quarter GDP growth came in at only 1.3 percent compared to the 2.5 percent rate expected in the March forecast while growth in the fourth quarter of 2006 was revised down from 3.5 percent to 2.5 percent. The new forecast also expects only 2.5 percent growth over the next four quarters compared to 2.9 percent in March. The weaker expected growth over the next year is almost entirely due to a more severe downturn in residential fixed investment. Conversely, the new forecast assumes higher inflation in 2007 and lower inflation in 2008 than assumed in March as a result of higher energy prices this year which are still expected to drop sharply in the second half of this year. The forecast assumes the Federal Reserve will hold the federal funds rate steady at 5.25 until its August meeting at which time it will cut its target rate 25 basis points to 5.00 percent. The forecast assumes no further rate cuts through the end of 2009.

A comparison of the preliminary U.S. forecast with the forecast adopted in March is shown in Table 2.

The Washington employment forecast incorporates preliminary Quarterly Census of Employment and Wages (QCEW) data for the fourth quarter of 2006. The benchmark revision to the fourth quarter increased the estimate of December 2006 employment by 4,000. Employment growth from December through April was 12,600 less than assumed in the March forecast, mostly due to a 9,400 downward revision to growth in January. As a result, April's employment was 8,600 lower than expected in the March forecast.

We also have the QCEW wage data for the fourth quarter of 2006, which was unavailable to the BEA at the time of their latest personal income release. As a result, our estimates of wages in the fourth quarter differ from the published BEA estimates. The QCEW data indicate that fourth quarter wages were \$1.075 billion (0.8 percent) higher than expected in March. Software wages were \$0.079 billion (1.4 percent) higher than expected and other wages were \$0.996 billion (0.8 percent) higher. Nonwage personal income was \$0.203 billion (0.2 percent) above the March estimate. The revision to total personal income in the fourth quarter was an increase of \$1.279 billion (0.5 percent).

The forecast also reflects Seattle consumer price data through April 2007. After trailing the national average during 2002, 2003, and 2004, December-December Seattle core inflation (excluding food and energy) edged ahead of the national average in 2005, rising 2.3 percent compared to 2.2 percent. Core inflation in Seattle shot well ahead of the national average in 2006, rising 3.7 percent compared to 2.6 percent for the U.S. city average. Strong regional inflation continued in early 2007. Core Seattle prices rose at a 4.4 percent rate during the first four months of 2007 compared to 2.2 percent for the U.S. while the Seattle all items CPI rose at a 5.1 percent annual rate compared to the national rate of 4.8 percent.

The number of housing units authorized by building permit jumped 17,400 in the first quarter of 2007 to 59,500 from 42,100 in the fourth quarter of 2006. Single-family permits increased only 2,500 to 32,700 but multi-family permits soared 14,900 to 26,900. The second quarter of 2007 got off to a weaker start. April housing units authorized by building permit totaled 39,200 of which 30,900 were single-family and 8,200 were multi-family.

The new Washington forecast generally reflects the slower near term growth in the U.S. forecast. The exception is the construction sector. The national forecast shows an even more severe downturn than assumed in the March forecast but the Washington forecast continues to expect a slowing, but no significant decline. The very strong housing activity in the first quarter followed a very weak fourth quarter. We believe the underlying trend is close to 50,000 units with higher multi-family activity offsetting much of the decline in the single-family market. The forecast assumes that continued growth in nonresidential construction will also offset some of the residential weakness. The software employment forecast has been reduced mainly as a result of a downward revision to the historical data. Nevertheless, software employment is still expected to rise 8,700 from the fourth quarter of 2006 to the fourth quarter of 2009. The Washington aerospace employment forecast is virtually unchanged since March. As of April, the aerospace sector has added 16,600 jobs since the

trough in May 2004. The forecast expects another 3,400 new aerospace jobs by mid-2008 when employment is expected to level off at 80,900. This is still 32,200 (28.5 percent) lower than the previous peak in June 1998.

A comparison of the preliminary Washington forecast with the forecast adopted in March is shown in Table 3.

Review of the forecast by the Governor's Council of Economic Advisors is scheduled for Friday, June 1, 2007 at 10:00 a.m., in the Governor's Conference Room.

If you have any questions, please contact Bret Bertolin, Senior Economic Forecaster, at (360) 570-6106.

PLEASE NOTE:

Enclosed is a worksheet summarizing the preliminary forecast. **Council members are strongly encouraged to complete and return this worksheet either in person at the Governor's Council meeting or, if unable to attend, by FAX to (360) 753-7022.** This worksheet is relied on by the Forecast Council members and staff to gauge the reasonableness of the preliminary economic forecast and also serves as the basis of an alternative economic and revenue forecast.

Fluctuations in software wages cause significant distortions in overall wage and personal income trends. In particular, Microsoft's stock awards vest in the third quarter of each year. Microsoft also pays bonuses in the third quarter. Since the Bureau of Economic Analysis does not seasonally adjust software wages, this causes an apparent jump in wages in the third quarter of each year and drop in the fourth quarter. Other quarters are less affected. Also, Microsoft stock option income can vary widely from quarter to quarter and from year to year. The following table shows what growth would have been without these factors.

	2007Q2	2007	2008	2009:1,2
<u>Real Personal Income, %Ch.</u>				
Baseline	-0.2	4.8	4.7	4.2
Excluding Software	0.9	4.7	4.6	4.7
Difference	-1.1	0.1	0.1	-0.5
<u>Average Annual Wage, %Ch.</u>				
Baseline	-1.1	4.5	4.0	3.3
Excluding Software	0.8	4.4	3.9	4.4
Difference	-1.9	0.0	0.1	-1.1

The weak second quarter growth in wages and real personal income reflect the U.S. forecast for wages which shows a very strong first quarter followed by a very weak second quarter. The forecast assumes that the average growth in non-software real personal income in the first two quarters of 2007 is 4.0 percent while the average growth in nominal wages excluding software is 4.5 percent.

Table 1

U.S. Economic Forecast Comparison

May 2007

	2007Q1	2007Q2	2007Q3	2007Q4	2006	2007	2008	2009
Real GDP, Percent Change								
Global Insight	1.3	2.2	2.4	2.6	3.3	2.1	2.8	3.3
Blue Chip	1.3	2.4	2.6	2.9	3.3	2.2	2.9	
Economy.com	1.3	2.2	2.7	3.2	3.3	2.1	3.0	
S&P	1.3	2.5	2.7	2.9	3.3	2.2	3.0	3.1
Merril Lynch	0.6	1.9	2.0	2.0	3.3	1.7	2.6	
Federal Funds Rate								
Global Insight	5.26	5.25	5.10	5.00	4.96	5.15	5.00	5.00
Blue Chip*	5.3	5.4	5.3	5.0	5.0	5.3	5.0	
Economy.com	5.3	5.3	5.3	5.3	5.0	5.3	5.3	
S&P	5.3	5.3	5.3	5.2	5.0	5.2	4.7	4.5
Consumer Price Index, Percent Change								
Global Insight	3.8	4.9	0.2	0.9	3.2	2.2	1.7	2.0
Blue Chip	3.8	3.7	2.3	2.1	3.2	2.4	2.4	
Economy.com	3.8	3.9	1.9	2.1	3.2	2.3	2.2	
S&P	3.8	4.9	0.3	0.9	3.2	2.2	1.7	2.0
Merril Lynch	3.8	5.4	2.3	0.5	3.2	2.6	1.7	
Payroll Employment, Millions								
Global Insight	137.4	137.8	138.0	138.3	136.2	137.9	139.3	141.4
%Ch						1.3	1.1	1.5
Economy.com	137.5	137.7	137.9	138.2	136.2	137.8	139.1	
%Ch						1.2	0.9	
S&P	137.4	137.8	138.1	138.4	136.2	137.9	139.6	141.7
%Ch						1.2	1.2	1.5
Unemployment Rate, Percent								
Global Insight	4.5	4.6	4.8	4.8	4.6	4.7	4.9	4.7
Blue Chip	4.5	4.6	4.7	4.7	4.6	4.6	4.8	
Economy.com	4.5	4.6	4.7	4.8	4.6	4.6	4.8	
S&P	4.5	4.6	4.7	4.7	4.6	4.6	4.7	4.6
Merril Lynch	4.5	4.6	4.7	4.9	4.6	4.7	5.0	
Real Disposable Personal Income, Percent Change								
Global Insight	4.5	0.1	4.4	4.0	2.6	3.2	3.5	3.7
Blue Chip	4.5	1.9	3.1	3.3	2.6	3.3	3.2	
Merril Lynch	4.5	-0.4	2.2	3.0	2.6	2.8	2.8	

* Estimate based on T-bill rate.

Table 2
U.S. Forecast Comparison

	2006Q3	2006Q4	2007Q1	2007Q2	2007Q3	2007Q4	2005	2006	2007	2008	2009
Real GDP (Billions of Chained 2000 Dollars)											
June	11443.5	11513.0	11549.1	11612.8	11681.9	11757.0	11048.6	11415.3	11650.2	11976.7	12369.7
Percent Change	2.0	2.5	1.3	2.2	2.4	2.6	3.2	3.3	2.1	2.8	3.3
March	11443.5	11541.6	11613.2	11692.4	11772.4	11855.7	11048.6	11422.4	11733.4	12083.7	12465.7
Percent Change	2.0	3.5	2.5	2.8	2.8	2.9	3.2	3.4	2.7	3.0	3.2
Implicit Price Deflator (2000=1.000)											
June	1.152	1.150	1.159	1.170	1.173	1.176	1.115	1.145	1.170	1.191	1.215
Percent Change	2.4	-1.0	3.3	3.9	0.9	1.2	2.9	2.7	2.1	1.8	2.0
March	1.152	1.150	1.155	1.160	1.167	1.172	1.115	1.146	1.163	1.188	1.212
Percent Change	2.4	-0.8	1.6	2.0	2.2	1.8	2.9	2.8	1.6	2.1	2.1
Real Personal Income (Billions of Chained 2000 Dollars)											
June	9492.6	9625.0	9758.0	9761.1	9865.6	9960.7	9183.2	9500.3	9836.4	10169.9	10550.8
Percent Change	2.6	5.7	5.6	0.1	4.4	3.9	2.3	3.5	3.5	3.4	3.7
March	9514.4	9647.9	9754.4	9844.2	9927.2	10015.4	9183.2	9511.4	9885.3	10232.8	10612.6
Percent Change	3.5	5.7	4.5	3.7	3.4	3.6	2.3	3.6	3.9	3.5	3.7
Wage and Salary Employment											
June	136.44	136.95	137.45	137.79	138.01	138.31	133.70	136.17	137.89	139.34	141.41
Percent Change	1.6	1.5	1.5	1.0	0.6	0.9	1.7	1.9	1.3	1.1	1.5
March	136.44	136.94	137.40	137.82	138.26	138.77	133.70	136.17	138.06	140.06	142.14
Percent Change	1.6	1.5	1.3	1.2	1.3	1.5	1.7	1.9	1.4	1.4	1.5
Unemployment Rate											
June	4.70	4.47	4.50	4.57	4.76	4.81	5.08	4.63	4.66	4.86	4.67
March	4.70	4.47	4.60	4.73	4.77	4.76	5.08	4.63	4.71	4.71	4.54
Mortgage Rate											
June	6.57	6.25	6.22	6.15	6.17	6.30	5.86	6.42	6.21	6.59	6.88
March	6.57	6.25	6.29	6.35	6.34	6.33	5.86	6.42	6.33	6.58	6.85
3 Month T-Bill Rate											
June	4.91	4.91	4.98	4.84	4.82	4.86	3.13	4.72	4.88	4.90	4.91
March	4.91	4.91	4.99	5.00	4.94	4.90	3.13	4.72	4.96	4.90	4.90

Table 3

Washington Forecast Comparison

	2006Q3	2006Q4	2007Q1	2007Q2	2007Q3	2007Q4	2005	2006	2007	2008	2009
Real Personal Income (Billions of Chained 2000 Dollars)											
June	210.948	212.117	215.404	215.303	223.266	221.929	200.221	208.981	218.975	229.234	239.936
Percent Change	9.3	2.2	6.3	-0.2	15.6	-2.4	0.1	4.4	4.8	4.7	4.7
March	210.236	210.921	213.802	215.902	223.078	221.517	200.260	208.499	218.575	228.884	239.435
Percent Change	7.6	1.3	5.6	4.0	14.0	-2.8	0.1	4.1	4.8	4.7	4.6
Personal Income											
June	243.080	243.844	249.670	251.962	261.879	261.087	223.232	239.396	256.150	273.004	291.550
Percent Change	11.8	1.3	9.9	3.7	16.7	-1.2	2.9	7.2	7.0	6.6	6.8
March	242.259	242.566	246.846	250.529	260.270	259.632	223.277	238.866	254.319	271.858	290.310
Percent Change	10.1	0.5	7.2	6.1	16.5	-1.0	3.0	7.0	6.5	6.9	6.8
Wage and Salary Employment											
June	2864.2	2882.5	2901.7	2911.8	2925.2	2939.9	2776.9	2858.5	2919.6	2978.9	3038.2
Percent Change	1.7	2.6	2.7	1.4	1.9	2.0	2.8	2.9	2.1	2.0	2.0
March	2862.9	2882.6	2906.3	2920.9	2935.9	2953.1	2776.9	2858.2	2929.1	2996.2	3056.9
Percent Change	1.5	2.8	3.3	2.0	2.1	2.4	2.8	2.9	2.5	2.3	2.0
Manufacturing Employment											
June	286.6	288.0	289.8	289.0	289.2	290.3	272.6	285.4	289.6	290.8	292.0
Percent Change	4.0	1.8	2.5	-1.1	0.4	1.4	3.4	4.7	1.5	0.4	0.4
March	286.7	289.6	291.3	290.3	290.6	291.4	272.6	285.8	290.9	291.9	292.4
Percent Change	4.0	4.2	2.3	-1.3	0.4	1.1	3.4	4.8	1.8	0.3	0.2
Construction Employment											
June	196.1	199.1	202.5	203.3	203.0	203.4	177.3	195.1	203.0	204.4	205.3
Percent Change	3.8	6.3	7.0	1.5	-0.5	0.9	8.0	10.0	4.1	0.7	0.4
March	196.0	199.0	200.5	199.2	198.5	199.3	177.3	195.0	199.4	201.4	202.5
Percent Change	3.5	6.3	3.0	-2.6	-1.4	1.7	8.0	9.9	2.2	1.0	0.5
Housing Permits											
June	53.036	42.084	59.528	46.295	49.601	49.434	52.988	50.033	51.215	48.914	48.149
Percent Change	-8.6	-60.4	300.3	-63.4	31.8	-1.3	5.8	-5.6	2.4	-4.5	-1.6
March	53.307	42.186	42.698	46.448	48.737	49.640	52.988	50.172	46.881	49.076	48.037
Percent Change	-8.2	-60.8	4.9	40.0	21.2	7.6	5.8	-5.3	-6.6	4.7	-2.1

Advisor's Name: _____

Forecast Worksheet
May 29, 2007

	2007:Q2	2007	2008	2009:1,2
<u>U.S.</u>				
Real GDP, %Ch				
Baseline	2.2	2.1	2.8	3.3
Your Opinion	_____	_____	_____	_____
Implicit Price Deflator, % Ch				
Baseline	3.9	2.1	1.8	2.1
Your Opinion	_____	_____	_____	_____
Mortgage Rate, Percent				
Baseline	6.2	6.2	6.6	6.8
Your Opinion	_____	_____	_____	_____
Oil Price (WTI)				
Baseline	64.7	62.1	61.4	62.2
Your Opinion	_____	_____	_____	_____
Probability next recession begins on or before 2009Q2		_____		
<u>Washington State</u>				
Real Personal Income, % Ch*				
Baseline	-0.2	4.8	4.7	4.2
Your Opinion	_____	_____	_____	_____
Wage and Salary Employment, % Ch				
Baseline	1.4	2.1	2.0	2.0
Your Opinion	_____	_____	_____	_____
Manufacturing Employment, % Ch				
Baseline	-1.1	1.5	0.4	0.5
Your Opinion	_____	_____	_____	_____
Construction Employment, % Ch				
Baseline	1.5	4.1	0.7	0.3
Your Opinion	_____	_____	_____	_____
Housing Permits (Thousands)				
Baseline	46.3	51.2	48.9	48.3
Your Opinion	_____	_____	_____	_____
Washington Average Annual Wage, % Ch*				
Baseline	-1.1	4.5	4.0	3.3
Your Opinion	_____	_____	_____	_____

* Please see important table on page three of the memo.